ENT-59 REDUCE THE REPLACEMENT RATE WITHIN EACH BRACKET OF THE SOCIAL SECURITY BENEFIT FORMULA

Savings from Current-Law Spending	Annual Savings (Millions of dollars) 1996	1997	1998	1999	2000	Cumulative Five-Year Savings
Outlays	160	620	1,290	2,100	2,940	7,110

Under current law, the basic Social Security benefit is determined by a formula that provides workers with 90 percent of their average indexed monthly earnings (AIME) up to the first bend point (which defines the first earnings bracket), plus 32 percent of the AIME in the second bracket, plus 15 percent of the AIME above the second bend point. One method of reducing initial Social Security benefits would be to lower these three rates by a uniform percentage.

Lowering the three rates in the benefit formula from 90, 32, and 15 percent to 87.3, 31.0, and 14.6 percent, respectively, would achieve an essentially uniform 3 percent reduction in the benefits of newly eligible workers starting in 1996. Thus, a 62-year-old retiree who has always earned the average wage would receive initial benefits in 1996 of about 33 percent of preretirement earnings, compared with 34 percent if no change was made.

This reduction in the replacement rates would lower Social Security outlays by about $7.1 billion over the 1996-2000 period and by more in later years. Moreover, this option would reduce the benefits of all future retirees by essentially the same percentage. Furthermore, the option could be combined with a one-time cut in the cost-of-living adjustment to ensure that benefits for both current and future recipients would be reduced to a similar extent (see ENT-67). The combination would generate substantial budgetary savings, while having a relatively small impact on both current and future beneficiaries.

Opponents contend that the Social Security Amendments of 1983 have already sharply reduced the benefits of future retirees and that further reductions would be unfair. In particular, the age at which unreduced Social Security retirement benefits are first available will rise in stages from 65 to 67 for workers turning 62 between 2000 and 2022. As a consequence, benefits for workers retiring after the turn of the century will be less than what would have been received had the full retirement age not been increased. For example, a worker who retires at age 62 in 2022 will receive 70 percent of the primary insurance amount, compared with 80 percent for a worker who retired at age 62 in 1995.

An alternative method of reducing Social Security benefits would leave replacement rates unchanged but narrow the AIME brackets over which those rates apply, perhaps by reducing the pace at which the brackets are indexed for inflation. This approach would exempt beneficiaries with the lowest AIME from the cut, but would impose benefit reductions unevenly among other recipients.

ENT-60 LENGTHEN THE SOCIAL SECURITY BENEFIT COMPUTATION PERIOD BY THREE YEARS

Savings from Current-Law Spending	Annual Savings (Millions of dollars) 1996	1997	1998	1999	2000	Cumulative Five-Year Savings
Outlays	40	170	450	860	1,400	2,900

Social Security retirement benefits are based on the average indexed monthly earnings (AIME) of workers in jobs covered by the system. The present formula computes AIME based on workers' best 35 years of employment. Lengthening the averaging period would generally lower benefits slightly by requiring more years of lower earnings to be factored into the benefit computation. This option would increase the AIME computation period gradually until it reached 38 years for people turning 62 in 1998 or beyond. This approach would save $2.9 billion over the next five years and more in later years.

One argument for a longer computation period is that people are now living longer and the normal retirement age for the Social Security program will be raised beginning in 2000. In addition, lengthening the averaging period would reduce the advantage that workers who postpone entering the labor force have over those who get jobs at younger ages. Because many years of low or no earnings can be ignored in calculating AIME, the former group currently experiences little or no loss of benefits for its additional years spent not working and thus not paying Social Security taxes.

Because some beneficiaries elect early retirement for such reasons as poor health or unemployment, it is argued that this proposal would adversely affect recipients who are least able to continue working. Other workers who would be disproportionately affected include those with significant periods outside the Social Security system, such as parents--usually women--who interrupted their career to rear children and workers who experienced long periods of unemployment.

ENT-61 ELIMINATE SOCIAL SECURITY BENEFITS FOR CHILDREN OF RETIREES AGES 62-64

Savings from Current-Law Spending	Annual Savings (Millions of dollars) 1996	1997	1998	1999	2000	Cumulative Five-Year Savings
Outlays	80	240	420	510	510	1,770

Unmarried children of retired workers are eligible for Social Security benefits as long as they are under age 18, or attend elementary or secondary school and are under age 19, or become disabled before age 22. A child's benefit is equal to one-half of the parent's basic benefit, subject to a dollar limit on the maximum amount receivable by any one family. If such benefits were eliminated for the children of retirees ages 62 through 64, beginning with retirees reaching 62 in October 1995, the savings would total $1.8 billion over the next five years.

This option might encourage some early retirees to stay in the labor force longer. At present, although benefits for retired workers and their spouses are actuarially reduced if retirement occurs before age 65, children's benefits are not. Further, the younger the workers are, the more likely they are to have children under 18. Thus, workers under 65 now have an incentive to retire while their children are still eligible for benefits, although this incentive is quite small for families in which spouses are also entitled to dependents' benefits. For these families, the increase in total benefits attributable to all eligible children cannot exceed 38 percent of the worker's primary insurance amount.

However, for families with workers whose retirement was not voluntary--because of poor health or unemployment, for example--the loss in family income might cause some hardship. Moreover, since spouses under 62 receive benefits only if their children under age 16 also receive benefits, eliminating children's benefits for families of early retirees would also result in the loss of entire benefits for spouses in some families. In such cases, the total loss of income would generally be large.

A different approach would apply the same actuarial reduction to children's benefits that is applied to the benefits of the worker on whom those benefits depend. Thus, for example, the child of a worker retiring at age 62 would receive a maximum of 40 percent of the parent's basic benefit, instead of the 50 percent that is currently allowed. Such an approach would avoid large losses in benefits for workers with young children, but would save less.

ENT-62 CONSIDER VETERANS' COMPENSATION WHEN DETERMINING SOCIAL SECURITY DISABILITY INCOME PAYMENTS

Savings from Current-Law Spending	Annual Savings (Millions of dollars) 1996	1997	1998	1999	2000	Cumulative Five-Year Savings
			Coordinate Benefits for All Veterans Receiving Compensation			
Outlays	75	110	120	130	140	575
			Coordinate Benefits for Veterans Newly Awarded Compensation			
Outlays	10	20	30	45	55	160

People with disabilities may qualify for cash payments from more than one source, including the Social Security Disability Insurance (DI) program, veterans' compensation, workers' compensation, means-tested programs like the Supplemental Security Income program, and private disability insurance. If they are younger than 65 and covered under Social Security, workers who are unable to work because they are physically or mentally impaired may qualify for DI payments.

When Social Security beneficiaries are eligible for multiple disability benefits, ceiling arrangements limit combined public disability benefits to 80 percent of the workers' average earnings before they were disabled. The combined payment after the reduction is adjusted periodically for changes in the cost of living and in national average wage levels. Veterans' compensation payments for disabilities, however--as well as means-tested benefits and certain benefits based on public employment--are not included when applying the ceiling.

Approximately 2.2 million veterans--about 1.2 million of whom are under age 65--receive compensation for service-connected disabilities. The amount of compensation is based on a rating of an impairment's average effect on a person's ability to earn wages in civilian occupations. Additional allowances are paid to veterans whose disabilities are rated 30 percent or higher and who have dependent spouses, children, or parents. An estimated 125,000 veterans who receive compensation also receive DI payments from the Social Security program.

This option, which has two variations, would include veterans' compensation within the scope of the ceiling. (The combined payment, however, would never be less than either the DI benefit or the veterans' compensation payment.) Under both versions, compensation would be totaled when determining how much the DI benefit of an individual who is under 65 years old would be reduced to keep the combined benefit from exceeding the ceiling. One version of the option would apply this change to all current and future recipients of veterans' disability compensation. The other version would limit application of the option to veterans who newly qualify for disability compensation.

Applying the change to both current and future recipients of veterans' compensation would affect an estimated 30,000 recipients in 1996 and would save an estimated $575 million over the 1996-2000 period. Applying the change only to veterans who are newly awarded compensation payments would affect an estimated 15,000 recipients by 2000 and would save an estimated $160 million over the 1996-2000 period.

Putting these options into effect would mean that an explicit policy would determine the total amount of public compensation for veterans who have service-connected disabilities. Thus, the federal government would treat in a more consistent way people who receive cash disability payments from multiple programs that are not means-tested. Both versions of the option could, however, be seen as subjecting veterans' compensation benefits to a form of income testing. Moreover, under the variation of this option that would apply to current recipients of disability compensation, the incomes of some disabled veterans would drop.

ENT-63 END VETERANS' COMPENSATION PAYMENTS FOR CERTAIN VETERANS WITH LOW-RATED DISABILITIES

Savings from Current-Law Spending	Annual Savings (Millions of dollars) 1996	1997	1998	1999	2000	Cumulative Five-Year Savings
Budget Authority	660	679	690	703	716	3,447
Outlays	607	677	689	702	771	3,446

Approximately 2.2 million veterans who have service-connected disabilities receive veterans' disability compensation benefits. The amount of compensation is based on a rating of the individual's impairment that is intended to reflect an average reduction in the ability to earn wages in civilian occupations. Demonstrated loss of income, however, is not a requirement for eligibility. Veterans' disability ratings range from zero to 100 percent (most severe). Veterans unable to maintain gainful employment who have ratings of at least 60 percent are eligible to be paid at the 100 percent disability rate. Additional allowances are paid to veterans who have disabilities rated 30 percent or higher and who have dependent spouses, children, or parents. Receiving veterans' disability compensation does not affect the level of Social Security disability benefits to which an individual may be entitled (see ENT-62).

Currently, 1.3 million veterans have disability ratings below 30 percent and receive benefits of between $71 and $170 a month. Federal outlays could be reduced by $3.4 billion during the 1996-2000 period by ending disability benefits for low-rated disabilities, except for veterans with moderate or low family income. The income threshold used for this illustration is the median income of all families, which was about $37,000 in 1992. Thresholds that varied by family size might be a better measure of need, but the necessary information about the size of the families of the veterans who would be affected by this option was not available. (See ENT-68 for options to restrict eligibility for most non-means-tested entitlement programs, including veterans' compensation, on the basis of family income.)

Eliminating compensation benefits for veterans with disability allowances below 30 percent and relatively high family income would concentrate spending on the most impaired veterans. Because performance in civilian jobs depends less now on physical labor than when the disability ratings were originally set, and because improved reconstructive and rehabilitative techniques are now available, physical impairments rated below 30 percent may not reduce veterans' earnings. Low-rated disabilities include conditions such as mild arthritis, moderately flat feet, or amputation of part of a finger--conditions that would not affect the ability of veterans to work in many occupations today.

Veterans' compensation could be viewed, however, as career or lifetime indemnity payments owed to veterans disabled to any degree while serving in the armed forces, regardless of family income. Moreover, some disabled veterans--especially older ones who have retired--might find it difficult to increase their working hours or otherwise make up the loss in compensation payments.

ENT-64 END VETERANS' DISABILITY AND DEATH COMPENSATION AWARDS IN FUTURE CASES WHEN A DISABILITY IS UNRELATED TO MILITARY DUTIES

Savings from Current-Law Spending	1996	1997	1998	1999	2000	Cumulative Five-Year Savings
	Annual Savings (Millions of dollars)					
Budget Authority	21	89	197	323	465	1,095
Outlays	19	81	184	309	500	1,093

Veterans are eligible for disability compensation if they either receive or aggravate disabilities during active military service. Service-connected disabilities are currently defined as those resulting from diseases, injuries, or other physical or mental impairments that occurred or were intensified during military service, excluding those resulting from willful misconduct. Disabilities need not be incurred or made worse while performing military duties to be considered service-connected; for example, disabilities incurred while on leave also qualify. The federal government gives death compensation awards to survivors when a service-connected disability is related to the cause of death.

As many as 50 percent of veterans receiving compensation payments may be receiving compensation for injuries or diseases not related to the performance of military duties. Ending disability and death compensation awards in future cases in which a disability is neither incurred nor aggravated while performing military duties would reduce outlays by more than $1 billion. Approximately 5 percent of these savings would come from reduced death compensation awards.

This option would make disability compensation of military personnel comparable with disability compensation of federal civilian employees under workers' compensation arrangements. Because military personnel are assigned to places where situations may sometimes be volatile, however, they have less control than civilians over where they spend their off-duty hours. Therefore, in many cases it might be difficult to determine whether a veteran's disease, injury, or impairment was entirely unrelated to military duties. The formal appeals system of the Department of Veterans Affairs (VA) could be extended to cover rulings specifying that disabling conditions were unrelated to military duties.

Data collected by the VA indicate that about 230,000 veterans currently receive VA compensation payments totaling $1.5 billion a year for diseases that the General Accounting Office (GAO) reports are generally neither caused nor aggravated by military service. The diseases include arteriosclerotic heart disease, diabetes mellitus, multiple sclerosis, Hodgkins disease, chronic obstructive pulmonary disease (including chronic bronchitis and pulmonary emphysema), hemorrhoids, schizophrenia, osteoarthritis, and benign prostatic hypertrophy. Ending new awards for veterans with those diseases would have a more limited impact than this option because it would not affect all veterans whose compensable disabilities are not connected with military service. It could, however, eliminate compensation for some veterans whose disabilities the GAO finds are not generally service-connected but whose circumstances constitute an exception from this general conclusion. That approach would yield smaller savings than the previous measure--about $634 million over the 1996-2000 period.

ENT-65 ELIMINATE "SUNSET" DATES ON CERTAIN PROVISIONS FOR VETERANS IN THE OMNIBUS BUDGET RECONCILIATION ACT OF 1993

Savings from Current-Law Spending	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1996	1997	1998	1999	2000	
Reduce Pensions to Medicaid Nursing Home Residents						
Budget Authority	0	0	0	199	206	405
Outlays	0	0	0	198	246	439
Verify Income Reported for Pension Purposes						
Budget Authority	0	0	0	5	15	20
Outlays	0	0	0	5	15	20
Recover Certain Medical Care Costs for Veterans from Third Parties						
Budget Authority	0	0	0	211	222	433
Outlays	0	0	0	211	222	433
Impose Copayments for VA Medical Care						
Budget Authority	0	0	0	31	32	63
Outlays	0	0	0	31	32	63
Eliminate All Sunset Dates						
Budget Authority	0	0	0	446	475	921
Outlays	0	0	0	445	515	960

Four provisions in law that affect veterans will cease to apply on September 30, 1998--their "sunset" date. As a result, starting in 1999, outlays will be higher than if the provisions remained in effect. These provisions have:

- Protected the monthly benefit for certain pensioners without dependents who are eligible for Medicaid coverage for nursing home care, thus saving the Department of Veterans Affairs (VA) pension costs but increasing costs for the Medicaid program, which is paid for by the federal and state governments.

- Authorized the Internal Revenue Service to help the VA verify incomes reported by beneficiaries, for the purpose of establishing eligibility for pensions and benefits.

- Authorized the VA to collect from any health insurer that contracts to insure a veteran with service-connected disabilities the reasonable cost of medical care provided by the VA for the treatment of non-service-connected disabilities.

- Authorized the VA to charge copayments to certain veterans receiving inpatient and outpatient care and outpatient medication from agency facilities.

This option would make the effects of these provisions permanent by eliminating the sunset date in each case. If all four provisions were made permanent, savings from current-law spending during the 1996-2000 period would total almost $1 billion.

The main advantage of this option is that it would convert the temporary savings achieved by these provisions into continuing savings. The main disadvantage of the option is that certain veterans or their insurers would be worse off financially. States would also face higher Medicaid costs because of withdrawn federal funds for nursing home care.

ENT-66 IMPOSE A COST-OF-CAPITAL OFFSET FEE ON FANNIE MAE AND FREDDIE MAC

Savings from Current-Law Spending	Annual Savings (Millions of dollars) 1996	1997	1998	1999	2000	Cumulative Five-Year Savings
Budget Authority	700	700	700	700	700	3,500
Outlays	700	700	700	700	700	3,500

The interest rate that a firm must pay to borrow money depends on its credit rating. Greater financial strength in a borrower implies a higher level of credit quality (that is, less risk to the lender) and generally lowers the interest and other costs that borrowers must pay to obtain funds. But financial strength--especially when it is based on large amounts of shareholder-provided equity--comes at a price: shareholders must be compensated for the use of their money, which is tied up in raising the credit rating of the company.

The federal government helps government-sponsored enterprises (GSEs) reduce the cost of money from all sources by putting what is essentially the government's seal of approval on the GSEs' financial obligations. (A GSE is an enterprise that is established and chartered by the government for a specific financial purpose but is wholly owned by private stockholders.) That seal of approval consists of several provisions of law, including one that exempts the GSEs from many federal and state regulations designed to protect investors. Through such laws, the federal government sends a signal to investors that securities issued by a GSE are less risky than the GSE's financial condition would suggest. In other words, the federal government is a "shadow" provider of equity capital to the GSE: it stands in for other investors whose capital would be required in the government's absence to bolster the GSE's credit rating, and who would demand compensation for the use of their money.

As a consequence of the federal "presence," GSEs are able to obtain funds in the capital markets at lower interest rates than those paid by fully private borrowers of comparable financial condition. Although estimates are uncertain, two of the GSEs, the Federal National Mortgage Association (FNMA, or Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC, or Freddie Mac), probably save more than 30 cents (30 basis points) every year on every $100 of long-term debt they have because of their affiliation with the federal government. On mortgage-backed securities issued and guaranteed by the two GSEs, the cost advantage is smaller; nevertheless, it probably exceeds 5 cents (5 basis points) for every $100 of securities outstanding each year. Although those amounts might seem to be a small benefit, they add up to over $1.5 billion per year because Freddie Mac and Fannie Mae have over $1 trillion in outstanding securities. GSEs do not pay the government a fee or any other compensation for the reduced cost of capital they enjoy as a result of their status as sponsored enterprises.

More than 20 years ago, the federal government chartered Freddie Mac and Fannie Mae to give local, retail mortgage lenders a conduit to the vast sums of money available in the bond markets. In doing so, the government hoped to avoid periodic credit shortages for home buyers. Federal policy to give mortgage lenders access to Wall Street through Fannie Mae and Freddie Mac has clearly succeeded. In successfully channeling money from investors to home buyers and back to investors, the housing GSEs have demonstrated the profitability of such activity. As a consequence, credit is now reliably available to home buyers at all times. But an unfortunate side effect has been that the two GSEs now virtually monopolize the resale, or "secondary," market for fixed-rate home mortgages. In 1993, the volume of mortgages purchased by Fannie Mae and Freddie Mac exceeded one-half of all single-family mortgages that were originated. The GSEs dominate the market in part because the federal government's seal of approval helps reduce the cost of their borrowing.

An offset fee equal to one-half of the savings in capital costs that Freddie Mac and Fannie Mae derive from federal affiliation would be a step toward more equitable competition. In addition, it would compensate taxpayers for the value of the capital services that the government provides. Because of the differential effect of federal affiliation, separate fees should be applied to the GSEs' debt and to mortgage-backed securities (MBSs). (Such securities essentially give their buyers rights to share in the future stream of income generated by a large pool of mortgages put together by the GSE.) One-half of the estimated 30-basis-point saving on debt and one-half of the 5 basis-point-saving on MBSs imply a fee schedule of 15 and 2.5 basis points on the average amount of debt and of MBSs, respectively, that are outstanding each year. Outstanding debt and MBSs for the two GSEs currently stand at about $1.3 trillion ($300 billion of debt and $1 trillion of MBSs). Under the fee schedule proposed in this option, in 1994 federal revenues would have increased by about $700 million based on the GSEs' currently outstanding obligations.

Initially, the fee would reduce the GSEs' earnings, which are projected to total about $3 billion this year. The fee could also raise interest rates on mortgages that have a face value of $203,150 or less and that are eligible for purchase by Freddie Mac or Fannie Mae. If the GSEs were unable to shift any of the cost of the fee to others, their return on their shareholders' investments would fall by about one-fourth--Fannie Mae's from a projected 24 percent and Freddie Mac's from a projected 20 percent. But two effects would be likely to dampen the consequences of the fee for the GSEs' earnings. First, Freddie Mac and Fannie Mae would pass the fee on to others by charging higher interest rates on new mortgage purchases and higher fees on new MBSs. Second, both entities would be likely to shift their funding toward MBSs and away from debt securities, thus lowering the amount of fees they would have to pay. If the entire fee was passed on, home buyers could face interest rates that were up to 0.1 percentage point higher.

The fee discussed here has characteristics of both a user fee and a tax. That ambiguity makes it unclear whether the proceeds should be shown on the revenue side of the budget as governmental receipts or on the spending side as offsetting collections. On balance, however, the charge seems more closely to resemble a fee for services than a tax. Accordingly, this option credits collections from the fee to a Treasury account as offsetting receipts, which are paid into the general fund. That same treatment has been applied to such fees proposed in the budget requests of previous Presidents.

Several federal agencies, including the Congressional Budget Office, are now studying the feasibility and desirability of restructuring Freddie Mac and Fannie Mae into fully private firms. If the Congress decided to sever the federal government's links to these GSEs and revoke its "seal of approval," the cost-of-capital offset fee would need to be repealed.

ENT-67 RESTRICT COST-OF-LIVING ADJUSTMENTS IN NON-MEANS-TESTED BENEFIT PROGRAMS

Savings from Current-Law Spending	Annual Savings (Millions of dollars) 1996	1997	1998	1999	2000	Cumulative Five-Year Savings
	Eliminate COLAs for One Year					
Social Security/ Railroad Retirement	8,010	10,900	11,100	11,180	11,220	52,410
Other Non-Means-Tested Programs	970	2,550	2,580	2,650	2,770	11,520
Offsets in Means-Tested Programs and Medicare Premiums	-280	-380	-400	-410	-420	-1,890
Total	8,700	13,070	13,280	13,420	13,570	62,040
	Limit COLAs to Two-Thirds of the CPI Increase for Five Years					
Social Security/ Railroad Retirement	2,670	6,670	11,010	15,550	20,300	56,200
Other Non-Means-Tested Programs	190	830	1,440	2,310	3,050	7,820
Offsets in Means-Tested Programs and Medicare Premiums	-100	-300	-540	-1,100	-1,940	-3,980
Total	2,760	7,200	11,910	16,760	21,410	60,040
	Limit COLAs to the CPI Increase Minus 0.5 Percentage Points for Five Years					
Social Security/ Railroad Retirement	1,290	3,110	5,040	7,080	9,220	25,740
Other Non-Means-Tested Programs	170	660	1,110	1,710	2,260	5,910
Offsets in Means-Tested Programs and Medicare Premiums	-50	-110	-190	-380	-630	-1,360
Total	1,410	3,660	5,960	8,410	10,850	30,290
	Pay the Full COLA on Benefits Below a Certain Level and 50 Percent of the COLA on Benefits Exceeding That Level for Five Years					
Social Security/ Railroad Retirement	0	1,230	2,920	4,680	6,480	15,300

Under current policies, outlays for Social Security and other non-means-tested cash transfer programs whose benefits are indexed to the consumer price index (CPI) are expected to total $430 billion in 1996 and to rise to $540 billion by 2000. Reducing the automatic cost-of-living adjustment (COLA) for these programs is commonly proposed as one way to slow the growth in entitlement spending. Four strategies for reducing COLAs and the savings in outlays resulting from each are shown in the preceding table. The programs in which COLAs would be reduced under the first three options are Social Security Old-Age, Survivors, and Disability Insurance; Railroad Retirement; Civil Service Retirement; Military Retirement; workers' compensation for federal employees; veterans' compensation; and retirement benefits for the Foreign Service, the Public Health Service, and the Coast Guard. The fourth option would affect only Social Security and Railroad Retirement Tier I COLAs. (Other options for achieving savings in Social Security are given in ENT-59 through ENT-62 and REV-15.)

COLA restrictions would achieve considerable savings by exacting small reductions in benefits from a large number of people, in contrast to other budget options that would impose large reductions in benefits on smaller groups of recipients. Moreover, limiting these options to the non-means-tested cash benefit programs would protect many of the poorest beneficiaries of entitlements--for example, recipients of Supplemental Security Income--from losses of income. Finally, because the benefit levels would be permanently lowered for those eligible when the COLA limitation was established, significant reductions in outlays would persist beyond the five-year projection period. The savings would eventually disappear, however, as beneficiaries died or stopped receiving payments for other reasons, unless the COLA limitation was accompanied by a permanent reduction in the initial benefits of newly eligible workers (see ENT-59).

Another argument in favor of less-than-complete price indexing is that the CPI probably overstates increases in the cost of living for the population as a whole. Although the amount of bias is not known, the existing empirical evidence indicates that recently the CPI has probably grown faster than the cost of living by between one-fifth and four-fifths of a percentage point a year. The magnitude of the bias--and even its direction--is less clear when the CPI is used as a measure of increases in the cost of living for the recipients whose benefits are indexed. (This evidence is reviewed in an October 1994 Congressional Budget Office paper, *Is the Growth of the CPI a Biased Measure of Changes in the Cost of Living?*) The Bureau of Labor Statistics, the agency that produces the CPI, continues to examine ways of improving the index. Because of the uncertainty about the magnitude of the bias, reductions in automatic COLAs for this reason might be premature.

Budget reduction strategies that institute less-than-complete price indexing would also result in financial difficulties for some recipients--particularly if COLAs were restricted for an extended period. Restrictions on COLAs also encounter opposition from those who fear that changes made to reduce budget deficits would undermine the entire structure of retirement income policy. For example, because private pension plans generally do not offer complete indexing, restricting Social Security COLAs would further reduce protection for beneficiaries against inflation. Some people also think that, because Social Security and other retirement programs represent long-term commitments to both current retirees and today's workers, these programs should be altered only gradually and then only for programmatic reasons. According to this view, any changes in benefits should be announced well in advance to allow people to adjust their long-range plans.

Unless restrictions on COLAs were accompanied by commensurate changes in determining initial benefits for new recipients, disparities in benefit levels would develop among different cohorts of retirees. This situation is particularly relevant for Social Security, in which benefits for newly eligible individuals are based on an indexed benefit formula and on indexed earnings histories. For example, if prices rose by 4 percent in a year and the wage index used to compute benefits for newly eligible recipients increased by 5 percent, the act of eliminating that year's COLA without changing the calculation of initial benefits would produce benefits for new beneficiaries that were about 5 percent higher than for recent retirees; under current law, benefits would be only about 1 percent higher for the new retirees. To alleviate this problem and to achieve additional savings, efforts to slow the growth in benefits through COLA limitations might be extended to the formulas for determining initial benefits (see ENT-59).

There are several options to restrict COLAs for current beneficiaries. Except for the option to limit COLAs to 2 percentage points less than the increase in the CPI, the magnitude of the savings in each case --as well as the impact on beneficiaries--would be very sensitive to the level of inflation in the years in which the COLAs would be reduced. If prices were to rise faster than currently assumed, savings would be greater than shown, and recipients would bear larger costs. If prices were to rise less quickly, both budgetary savings and the effect on recipients would be smaller.

The following are specific versions of COLA restrictions:

Eliminate COLAs for One Year. One option would be to eliminate COLAs in 1996 for non-means-tested benefit programs and allow them to be paid in subsequent years, but with no provision for making up the lost adjustment. If this approach was taken, federal outlays would be reduced by about $8.7 billion in 1996 and $62.0 billion over five years, with Social Security and Railroad Retirement accounting for most of the total.

Limit COLAs to Two-Thirds of the CPI Increase for Five Years. Under this approach, recipients would be compensated for only a certain proportion of inflation, such as two-thirds of the annual CPI increase. Under current economic assumptions by the Congressional Budget Office, applying this restriction for five years would save about $2.8 billion next year and $60 billion over the 1996-2000 period. As a result, benefits for people who received payments throughout the five-year period would be about 4 percent less in 2000 than they would have been under full price indexing. Furthermore, this option would reduce the real income of beneficiaries at the same time that they were becoming less able to supplement their income by working.

Limit COLAs to the CPI Increase Minus 0.5 Percentage Points for Five Years. An approach similar to the proportionate COLA reduction would be to reduce the adjustment by a fixed number of percentage points; for example, set the adjustment at the CPI increase minus 0.5 percentage points. Unlike other options to restrict COLAs, however, both savings and effects on beneficiaries would be roughly the same regardless of the level of inflation--about $30 billion over the next five years, if extended for the full period.

Pay the Full COLA on Benefits Below a Certain Level and 50 Percent of the COLA on Benefits Exceeding That Level for Five Years. Another alternative would tie the COLA reductions to beneficiaries' payment levels, starting in 1997. The example discussed here--based only on Social Security and Railroad Retirement Tier I benefits--would award the full COLA for benefits based on the first $650 of a retiree's monthly primary insurance amount (PIA) and 50 percent of the COLA on benefits above that level. The $650 per month threshold is about equal to the projected 1997 poverty level for an elderly person and would be indexed to maintain its value over time.

This approach would save about $1.2 billion in 1997 and $15.3 billion over the 1997-2000 period. Because of the time needed to carry out this proposal, these estimates assume that it would be in place by January 1997.

Because the full COLA would be paid to beneficiaries with low PIAs, this option would ensure that low-income recipients were not adversely affected. Moreover, its percentage impact would be greater for recipients with higher benefits. Nonetheless, benefit levels are not always good indicators of total income. Some families with high benefits have little other income, while some with low benefits have substantial income from other sources. Furthermore, many people object to any changes in retirement programs that might be construed as introducing a means test for benefits, even if the test is limited only to the COLA.

A variation would extend this approach to the other non-means-tested benefit programs besides Social Security; this variation is not shown in the table. Such an option would spread the effects among a wider group of recipients, although it might be somewhat more complicated to design because the different benefit structure in each program could require a separate determination of the appropriate benefit levels on which to pay reduced COLAs.

Eliminating COLAs for recipients whose benefits are based on PIAs above a certain level is another option. Because this reduction would affect the entire benefit of each recipient above the threshold, not just the portion of the benefit above that level, both the savings and the impacts on beneficiaries would be considerably greater. Unless adjustments were made at the threshold, however, recipients with benefits just below the threshold could be made better off than those with benefits just above it. Still another approach that would address some of the administrative problems of these two options would involve increased taxation of Social Security benefits (see REV-15).